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David S. Guzy, Chief
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Royalty Management Program
Minerals Management Service
Denver Federal Center, Building 85
P. O. Box 25165, Mail Stop 3101,
Denver, Colorado 80225-0165

Re: New Mexico Comments on MMS's Advance Notice of Rulemaking on Valuation of Oil from Federal and Indian Leases

Dear Mr. Guzy:

The Taxation and Revenue Department and the State Land Office of the State of New Mexico submit the following written comments on MMS's advance notice of proposed rulemaking, as published in the Federal Register on December 20, 1995.

Alternatives to Valuation Based on Oil Posted Prices. MMS has solicited comments on the continued applicability of oil posted prices and alternative methods of valuation. Specifically, comments are sought regarding the use of indices or reference prices as an alternative to the prices posted by individual companies in the field. New Mexico believes there are reliable reference prices available. On a national level, the New York Mercantile Exchange ("NYMEX") publishes a daily record of trades in oil for future delivery in Cushing, Oklahoma. According to the Crude Oil Advisory Committee for NYMEX, "the NYMEX Division light, sweet crude oil futures contract is the most actively traded futures contract for a physical commodity, along with one of the most widely used crude oil price indices in the world." On a regional level, alternative markets exist that pay premiums over posted field prices. For New Mexico production, the premiums paid in this "Posting-Plus" market are published each trading day by *Platt's Oilgram.*

Although companies object to the use of futures prices, we believe that NYMEX and other regional markets represent a far more reliable basis for establishing oil value than the posted prices currently used by industry. The NYMEX market is a competitive, regulated market trading high volumes among a large number of participants. The price of oil on the NYMEX market is based on actual trades and can be accessed 24 hours a day. In contrast, posted prices are privately set by individual companies. In our experience, most companies are unwilling to adequately explain the underlying basis of their pricing methodology. The situation is further complicated by the fact that some major companies refuse to buy oil at their posted prices when the seller is anyone other than an affiliated entity. However, we recognize that historically posted prices have been used as a basis of settlement in arm's-length transactions in which premiums and bonuses may have been involved.

Even within the same field, posted prices vary widely from company to company. An example of these disparities can be seen in the following comparison of 13 company postings prepared by the New Mexico Taxation and Revenue Department.

Sweet Crude Oil Postings for April 1995:

High:	$19.18
Low:	$18.18

Sour Crude Oil Postings for April 1995:

High:	$18.08
Low:	$16.18

A second comparison reveals that the per-barrel price reported to the Department in December 1994 on sales of oil from a single property varied from a high of $16.163 per barrel to a low of $13.235 per barrel. For a more detailed analysis of the variations between company postings, we refer you to the graphic representation of posted prices included with the presentation made at the February 1996 STRAC meeting in Denver.

New Mexico sees no way to reconcile the differences among posted field prices. This conclusion is based on the consistent and continuing disparity between high and low postings; the oil companies' unwillingness to explain the basis for their postings; and the fact that some postings do not represent true offers, since significant amounts of oil purchased at the posted price is owned by affiliated entities. It should also be recognized that with the increased number of sales between affiliated entities and the widespread use of buy/sell and exchange agreements, the first arm's-length sale of most oil now occurs away from the lease (see discussion on buy/sell agreements, below). Rather than attempting to reconcile field prices that do not reflect current marketing practices, New Mexico encourages MMS to look to established market centers as the starting point for valuation.

In response to the request for alternative valuation methods, we recommend the following:

1. For all non-arm's-length sales, begin with an index or reference price that corresponds with the NYMEX or with other recognized markets such as posting-plus. This posting plus market trades a differential to a specific posting agreed by traders.

2. Allow a deduction for the cost of transporting the product from the field to market. This may be represented by a trucking fee, a pipeline fee, or by the price differential in a buy/sell or exchange agreement.

3. Allow a deduction to adjust for differences in the quality or location of the oil reflected in the index price selected.

In connection with the third step of our proposed valuation method, MMS has asked whether there are fixed prices against which quality, transportation and other adjustments can be made to develop reasonable royalty values. The answer is yes. Assume, for example, that the Posting-Plus market for West Texas Intermediate ("WTI") crude to be delivered at Cushing Oklahoma, is selected as the index price. In determining royalty due on a non-arm's-length sale of West Texas Sour ("WTS") crude at Midland, Texas, a lessee would be entitled to deduct the difference in value between the price of WTI at Cushing and the price of WTS at Midland. These prices are tracked and published in *Platt's Oilgram* at the close of each market trading day. Platt's also tracks the price differentials between Cushing WTI and Midland WTI. The publication of prices on different grades of crude at different locations provide sufficient information to insure a consistent and equitable application of the above approach.

Determination of "Significant Quantities". The December 20, 1995 advance notice of proposed rulemaking asks for comments on MMS's current benchmark structure of recognizing posted price if significant quantities are sold or purchased at arm's-length. Comments are sought on four specific issues. As set out under Issue 4, below, the State of New Mexico believes that the concept of "significant quantities" no longer reflects the reality of today's market and should be replaced. Nonetheless, we are providing comments on the first three issues as well.

1. Is there an absolute volume measure (barrels per day/month/year, etc.) that would allow MMS to determine whether specific arm's-length sales involve "significant quantities"? If so, should this volume vary by field or area?

Comment: Absolute volume measurements should not be used to determine "significant quantities." As both federal and state auditors can verify, there is no consistency in production volumes, which vary widely from month to month, from field to field, and from area to area. Given these fluctuations, an absolute volume measure is not a practical method of determining "significant quantities", nor will it satisfy MMS's stated goal of enacting regulations that will meet future as well as current conditions.

2. Is there a fixed percentage of field or area production that MMS can use as a comparison basis to determine whether specific arm's-length sales represent "significant quantities"?

Comment: In order to insure that non-arm's length sales represent fair value, MMS should require a lessee to show that at least fifty percent of his production is sold in arm's-length sales at a similar price. See comment under 3, below, regarding the comparative basis for determining whether such a fifty percent benchmark can be met.

3. What should be the comparative basis for "significant quantity" determinations? Should individual arm's-length transactions be related to *all* field production, or should some volumes such as internal company transfers of production or exchanges or buy/sell exchanges with other oil companies be excluded from field production?

Comment: Because an individual lessee does not have access to other producer's contracts, and because information on contract prices is clearly proprietary, it is not practical to ask a lessee to determine value based on sales other than his own. Nor can auditors be expected to survey all transactions in a particular field in order to determine whether arm's-length oil sales by the individual lessee under audit meet the "significant quantities" benchmark. Using all field production as the comparative basis for "significant quantities" is also problematic because any proprietary information obtained by an auditor concerning sales by other producers would be confidential. This would make it difficult for the auditor to substantiate that the sales of one lessee did not, in fact, meet the regulatory benchmark.

The comparative basis for "significant quantity" determinations should relate an individual lessee's arm's-length sales to the lessee's total sales. This is a comparison that each lessee can easily make to determine the basis on which to value his production for royalty purposes. It is also a method that an auditor can verify without having to engage in extensive research on unrelated transactions.

With regard to buy/sell and exchange agreements, New Mexico strongly urges MMS to issue regulations to establish that agreements between parties whose only opposing economic interest is in the price differential negotiated between the initial sale price and the later buy-back price do not qualify as arm's-length transactions. Assume, for example, that Party A enters into an agreement with Party B to sell oil at a posted field price of $14.00/barrel and to buy back an equivalent volume of like-quality oil at Cushing, Oklahoma, for $14.50/barrel. In this case, the only element of the price that affects the economic interest of either party is the 50 cent price differential. The parties could as easily agree to an initial sale price at the lease of $8.00 and a buy-back price at Cushing of $8.50. The economic reality of the transaction would remain the same. Under these circumstances, the lessee should not be allowed to use the initial sale price to establish market value for federal royalty purposes. Rather, the lessee should be required to value the oil according to the price for which it can be sold at Cushing, less a 50-cent per barrel transportation deduction.

4. Are there measures other than "significant quantities" that may better apply given alternative valuation scenarios?

Comment: Yes. New Mexico favors an approach that requires all non-arm's-length sales to be reported according to the methodology set out in the first section of this response. Using this methodology, there is no need for a "significant quantity" benchmark: when the first true, arm's-length sale of oil occurs in the field, the value is determined by purchase price; when the first arm's-length sale occurs away from the lease, the value is determined by the applicable market price, less a transportation deduction and a deduction reflecting any quality and location differentials.

Rulemaking Procedures. In our experience, it is very helpful to receive industry's input and view of proposed rules or regulations. In the final analysis, however, it is MMS's task to decide what is lawful and right to protect the interests of the federal government. To promulgate rules based on negotiation with and the consent of the industry being regulated is not a realistic goal and should be abandoned.

Conclusion. Although use of a reference price may not satisfy everyone, we believe that the price of oil at established market centers is a far more reliable indicator of value than the field postings of individual companies. It should be noted that this valuation approach is virtually identical to the approach adopted by the Federal, State and Industry RegNeg Committee in connection with the valuation of natural gas marketed in non-arm's-length situations. The reasons for adopting reference pricing in connection with gas are equally applicable to oil, including the need to develop a method of valuation that allows lessees to use information to which they have access and reduces uncertainty on royalty values acceptable to MMS.

We appreciate the opportunity to comment on the proposed rules. If there is any way we can be of further assistance, please let us know.

Very truly yours,

John J. Chavez, Secretary
New Mexico Taxation and Revenue Department

Ray Powell

Ray Powell, Commissioner of Public Lands
New Mexico State Land Office